



STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY

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John G. Morgan
Comptroller

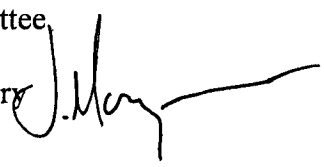
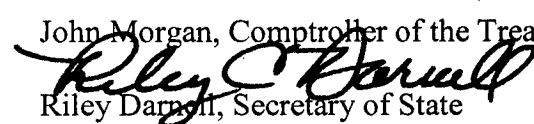
May 9, 2007

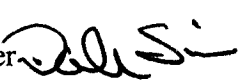
Memorandum

TO: Governor Phil Bredesen

Chairman Randy McNally
Senate Finance, Ways, & Means Committee

Chairman Craig Fitzhugh
House Finance, Ways, & Means Committee

FROM: John Morgan, Comptroller of the Treasury 

Riley Darnell, Secretary of State

Dale Sims, State Treasurer 

M.D. Goetz, Jr., Commissioner
Department of Finance & Administration 

SUBJECT: Revenue Estimates for FY 2006-07 and FY 2007-08

The State Funding Board met on May 7 and May 9, 2007 to hear updated presentations on, and to engage in discussions about, the State's near-term economic outlook for the fiscal years 2006-07 and 2007-08.

The Board is charged by T.C.A. Section 9-4-5202(e) with responsibility to develop consensus ranges of state revenue growth. In doing so, the Board evaluates and interprets economic data and revenue forecasts supplied by various economists as well as persons acquainted with the Tennessee revenue system. This is a revenue estimation process and **not** a budgeting process. The Board does not take into consideration the State's fiscal situation when developing its consensus ranges of revenue growth; however, the Board does strive to have the highest degree of confidence in the State's ability to achieve such growth. The consequences of overestimating growth in revenues was made clear by an analysis prepared by The University of Tennessee Center for

Business and Economic Research and presented by Dr. William Fox, a copy of which is attached.

In the "Rainy Day Funds: Analysis and Recommendations for Tennessee" state operating reserve funds are considered from three different perspectives: bond rating agencies' recommendations; academic approaches to evaluating and sizing such funds; and simulation analysis using Tennessee's actual experience during the last three recessions. The reserve funds, called "rainy day funds," are used to fund necessary expenses during tight economic periods without having to make significant changes to revenue policy, such as raising tax rates. The Revenue Fluctuation Reserve Fund (created by T.C.A. Section 9-4-211) is the State's rainy day fund. Dr. Fox noted that the impact of recessions transcend fiscal years, a factor to consider when evaluating funding levels. Under the various simulations for Tennessee, even with a mild recession, significant reductions in the growth of state expenditures, along with utilization of the fund balance in the Revenue Fluctuation Reserve Fund, would be required. The Governor's budget for fiscal year 2007-08 would fully fund the current reserve requirement of 5% of estimated state tax revenues to be allocated to the general fund. Dr. Fox concluded with a recommendation that the State develop a formal written policy governing use and replenishment of the rainy day fund and that the reserve requirement be increased at least to 11% of general fund state tax revenues.

The Board then heard economic testimony from Dr. Fox, Mr. Jim White and Mr. Robert Currey of the Fiscal Review Committee, and Mr. Reid Linn of the State Department of Revenue. The state tax revenue estimates provided by each of the presenters are summarized in two attachments to this memorandum. One presenter observed that he had been more conservative in his revenue estimations due to the current coverage provided by the Revenue Fluctuation Reserve Fund.

The consensus is that growth in the economy will continue but will be modest. The presenters felt that the historically high growth rates experienced recently with Franchise and Excise taxes and with the Hall Income tax were not likely to continue.

Tennessee's tax system continues to depend upon healthy growth in sales tax collections. Such growth is in turn dependent on growth in per capita income resulting in increased discretionary income. During the past few years; the State has benefited from increased sales tax collections due to the growth in the construction sector; however, the rate of growth in the building materials category has dropped substantially in the past few months. The general merchandise category growth has increased substantially during the same time period.

The yield curve continues to be inverted; previously, the presenters had cautioned that historically, inverted yield curves preceded recessions. Both franchise and excise taxes collections and the international trade imbalance between exports and imports continue to cause the presenters some uneasiness with respect to their forecasts.

Based on the testimony received and the Board discussions, the Board developed the following summarized consensus estimates expressed in ranges of growth rates in State tax revenue collections:

	FY 2006-07		FY 2007-08	
	Low	High	Low	High
Total State Taxes	6.60%	6.90%	3.70%	4.00%
General Fund Only	6.50%	6.80%	3.70%	4.00%

The Board believes these consensus revenue growth ranges to be reasonable and appropriate for use in state budgeting and are based on statutory provisions enacted through the 104th General Assembly.

Additionally, the State Funding Board received presentations regarding the Tennessee Education Lottery (TEL). Tennessee Code Annotated Section 4-51-111(c) requires the Board to establish a projected revenue range for the "Net Lottery Proceeds" [defined in Section 4-51-102(14)] for the remainder of the current fiscal year and for the succeeding fiscal year. Mr. Robert Currey, Chief Economist, Fiscal Review Committee (FRC) presented to the Board the FRC's projections. Mr. Currey observed that the TEL is becoming a more mature lottery and natural sales growth is diminishing. He questioned whether TEL was close to profit maximization. He referenced the "sweet spot" or the optimum prize expense point after which subsequent increases to the prize payout ratio will have no or negative effect (the incremental revenue is less than the incremental increase in expenses).

For fiscal year 2007-08, the FRC projected a 2% growth in net ticket sales and a 0.6% growth in net lottery proceeds. The Net Lottery Proceeds available for deposit into the Education Account for fiscal years 2006-07 and 2007-08 are anticipated to be 27% of Net Revenue.

The Board additionally heard from Ms. Rebecca Paul Hargrove, the Chief Executive Officer and Mr. Andy Davis, Chief Financial and Technology Officer of the Tennessee Education Lottery Corporation (TELC). The TELC is continuing to estimate approximately 2% of prizes (excluding jackpot prizes) to be the amount for unclaimed prizes; 100% of which is to be deposited into the "after school programs special account" at the end of each fiscal year.

Ms. Hargrove agreed with FRC's assumptions used in estimating lottery revenues, confirming that net lottery proceeds are estimated to be 27% of net revenues for both fiscal years; however, she disagreed that TEL was approaching the "sweet spot" and anticipated higher growth in ticket sales for fiscal year 2007-08.

The Board then heard from Mr. David Wright, Assistant Director for Policy Planning and Research, of the Tennessee Higher Education Commission, and from Mr. Tim Phelps, Associate Executive Director for Grants and Scholarship Programs, of the Tennessee Student Assistance Corporation. Mr. Phelps confirmed in fiscal year 2005-06, there were 56,058 awards in the TEL Scholarship program, with an actual cost of \$136,844,971. He provided fiscal year 2006-07 projections of 59,750 awards, with a projected cost of \$185,000,000. Mr. Wright affirmed prior estimates for fiscal year 2007-08 (representing a fully mature program with no growth in first time freshmen) of 68,300 awards, with a projected cost of \$211,200,000. These awards include all lottery-funded scholarship programs as authorized through the 104th General Assembly.

The estimates provided by each of the presenters are summarized in an attachment to this memorandum. Consensus was reached on the following estimates of the range for net proceeds of lottery revenues to be deposited in the Lottery for Education Account, to be used for the various statutory purposes:

	FY 2006-07		FY 2007-08	
	Low	High	Low	High
Net Lottery Proceeds	\$266,600,000	\$272,000,000	\$266,100,000	\$278,000,000

These estimates assume no legislative changes regarding the TELC and its authority.

Each of us stands ready to discuss this further at your convenience.

Attachments

Revenue Estimates (2)
"Rainy Day Funds: Analysis and Recommendations"
Lottery Estimates
TSAC/THEC Report

cc. The Honorable Ron Ramsey
The Honorable Jimmy Naifeh

**COMPARISON OF ESTIMATED STATE TAX REVENUE FOR
FISCAL YEAR 2006-2007**

(Accrual - Basis Estimates)

Schedule 1

2006-2007											
DEPARTMENT OF REVENUE	2005-2006 ACTUAL ACCRUAL	2006-2007 BUDGETED ESTIMATE	% CHANGE OVER 05-06 ACTUAL	Jan. 2007 REVISED ESTIMATE	% CHANGE OVER 05-06 ACTUAL	DR. FOX ESTIMATE	% CHANGE OVER 05-06 ACTUAL	FISCAL REVIEW ESTIMATE	% CHANGE OVER 05-06 ACTUAL	REVENUE DEPT. ESTIMATE	% CHANGE OVER 05-06 ACTUAL
Sales and use Tax	\$ 6,515,643,000	\$ 6,805,300,000	4.45%	\$ 6,797,000,000	4.32%	\$ 6,809,800,000	4.51%	\$ 6,825,136,000	4.75%	\$ 6,810,000,000	4.52%
Gasoline Tax	605,598,900	597,000,000	-1.42%	597,000,000	-1.42%	602,000,000	-0.59%	613,274,000	1.27%	606,100,000	0.08%
Motor Fuel Tax	180,653,200	184,300,000	2.02%	184,300,000	2.02%	184,000,000	1.85%	186,073,000	3.00%	185,200,000	2.52%
Gasoline Inspection Tax	64,519,700	65,500,000	1.52%	65,500,000	1.52%	65,100,000	0.90%	65,487,000	1.50%	65,600,000	1.67%
Motor Vehicle Registration Tax	249,541,000	255,000,000	2.19%	255,000,000	2.19%	263,000,000	5.39%	262,018,000	5.00%	261,300,000	4.71%
Income Tax	194,367,900	203,500,000	4.70%	203,500,000	4.70%	244,900,000	26.00%	246,000,000	26.56%	243,000,000	25.02%
Privilege Tax - Less Earmarked Portion (1)	304,889,400	307,900,000	0.99%	307,900,000	0.99%	315,000,000	3.32%	317,085,000	4.00%	313,900,000	2.96%
Gross Receipts Tax - TVA	220,325,400	228,000,000	3.48%	250,200,000	13.56%	247,500,000	12.33%	247,482,000	12.33%	247,500,000	12.33%
Gross Receipts Tax - Other	20,841,400	21,800,000	4.60%	21,800,000	4.60%	19,000,000	-8.84%	22,500,000	7.96%	21,800,000	4.60%
Beer Tax	17,797,300	17,900,000	0.58%	17,900,000	0.58%	18,300,000	2.82%	18,153,000	2.00%	18,100,000	1.70%
Alcoholic Beverage Tax	39,208,200	39,900,000	1.76%	39,900,000	1.76%	40,500,000	3.29%	40,777,000	4.00%	40,600,000	3.55%
Franchise & Excise Taxes	1,491,616,000	1,531,000,000	2.64%	1,531,000,000	2.64%	1,746,300,000	17.07%	1,745,000,000	16.99%	1,715,400,000	15.00%
Inheritance and Estate Tax	76,287,700	71,000,000	-6.93%	71,000,000	-6.93%	88,000,000	15.35%	92,000,000	20.60%	89,600,000	17.45%
Tobacco Tax	124,872,300	125,000,000	0.10%	125,000,000	0.10%	132,000,000	5.71%	129,705,000	3.87%	128,600,000	2.99%
Motor Vehicle Title Fees	10,989,800	11,400,000	3.73%	11,400,000	3.73%	11,200,000	1.91%	11,210,000	2.00%	11,400,000	3.73%
Mixed Drink Tax	49,054,900	51,500,000	4.98%	51,500,000	4.98%	53,500,000	9.06%	52,489,000	7.00%	52,700,000	7.43%
Business Tax	121,663,200	124,200,000	2.09%	124,200,000	2.09%	127,800,000	5.04%	126,530,000	4.00%	127,100,000	4.47%
Severance Tax	1,754,100	1,400,000	-20.19%	1,400,000	-20.19%	1,500,000	-14.49%	1,600,000	-8.79%	1,400,000	-20.19%
Coin Operated Amusement Tax	304,400	300,000	-1.45%	300,000	-1.45%	300,000	-1.45%	300,000	-1.45%	300,000	-1.45%
Unauthorized Substance Tax	830,200	400,000	-51.82%	400,000	-51.82%	1,400,000	68.63%	1,800,000	116.82%	1,500,000	80.68%
TOTAL DEPARTMENT OF REVENUE	\$ 10,290,758,000	\$ 10,642,300,000	3.42%	\$ 10,656,200,000	3.55%	\$ 10,971,100,000	6.61%	\$ 11,004,619,000	6.94%	\$ 10,941,100,000	6.32%
GENERAL FUND ONLY (2)	\$ 8,622,222,100	\$ 8,905,000,000	3.28%	\$ 8,907,500,000	3.31%	\$ 9,195,300,000	6.65%	\$ 9,214,719,000	6.87%	\$ 9,161,700,000	6.26%
Growth over FY 07 Revised Estimate:											
Total						\$314,900,000		\$348,419,000		\$284,900,000	
General Fund						\$287,800,000		\$307,219,000		\$254,200,000	
SELECTED TAXES	ACTUAL	BUDGETED	%	REVISED	%	DR. FOX	%	FISCAL REVIEW	%	REVENUE DEPT.	%
SALES AND USE TAX	\$ 6,515,643,000	\$ 6,805,300,000	4.45%	\$ 6,797,000,000	4.32%	\$ 6,809,800,000	4.51%	\$ 6,825,136,000	4.75%	\$ 6,810,000,000	4.52%
FRANCHISE AND EXCISE TAXES	1,491,616,000	1,531,000,000	2.64%	1,531,000,000	2.64%	1,746,300,000	17.07%	1,745,000,000	16.99%	1,715,400,000	15.00%
INCOME TAX	194,367,900	203,500,000	4.70%	203,500,000	4.70%	244,900,000	26.00%	246,000,000	26.56%	243,000,000	25.02%
ROAD USER TAXES	1,100,312,800	1,101,800,000	0.14%	1,101,800,000	0.14%	1,114,100,000	1.25%	1,126,852,000	2.41%	1,118,200,000	1.63%
ALL OTHER TAXES	988,818,300	1,000,700,000	1.20%	1,022,900,000	3.45%	1,056,000,000	6.79%	1,061,631,000	7.36%	1,054,500,000	6.64%

(1) Privilege Tax estimates are reduced by \$32 million for the earmarked portion of the tax.

(2) F&A calculated the General Fund distribution for all presenters.

**COMPARISON OF ESTIMATED STATE TAX REVENUE FOR
FISCAL YEAR 2007-2008**

(Accrual - Basis Estimates)

Schedule 2

2007-2008								
DEPARTMENT OF REVENUE	Jan. 2007	% CHANGE		% CHANGE		% CHANGE		% CHANGE
SOURCE OF REVENUE	BUDGET DOCUMENT	OVER 06-07	DR. FOX	OVER 06-07	FISCAL REVIEW	OVER 06-07	REVENUE DEPT.	OVER 06-07
	ESTIMATE	ESTIMATE	ESTIMATE	ESTIMATE	ESTIMATE	ESTIMATE	ESTIMATE	ESTIMATE
Sales and use Tax	\$ 7,145,000,000	5.12%	\$ 7,116,200,000	4.50%	\$ 7,118,617,000	4.30%	\$ 7,116,800,000	4.51%
Gasoline Tax	602,000,000	0.84%	602,000,000	0.00%	616,340,000	0.50%	612,000,000	0.97%
Motor Fuel Tax	189,000,000	2.55%	189,000,000	2.72%	191,655,000	3.00%	189,200,000	2.16%
Gasoline Inspection Tax	65,500,000	0.00%	65,500,000	0.61%	66,469,000	1.50%	66,700,000	1.68%
Motor Vehicle Registration Tax	260,000,000	1.96%	268,300,000	2.02%	268,568,000	2.50%	270,700,000	3.60%
Income Tax	216,400,000	6.34%	254,700,000	4.00%	263,220,000	7.00%	253,900,000	4.49%
Privilege Tax - Less Earmarked Portion (1)	330,100,000	7.21%	330,700,000	4.98%	332,939,000	5.00%	322,700,000	2.80%
Gross Receipts Tax - TVA	261,100,000	4.36%	261,100,000	5.49%	257,381,000	4.00%	251,600,000	1.66%
Gross Receipts Tax - Other	19,400,000	-11.01%	19,400,000	2.11%	23,288,000	3.50%	22,400,000	2.75%
Beer Tax	18,300,000	2.23%	18,300,000	0.00%	18,516,000	2.00%	18,200,000	0.55%
Alcoholic Beverage Tax	41,400,000	3.76%	41,700,000	2.96%	42,408,000	4.00%	41,800,000	2.96%
Franchise & Excise Taxes	1,536,300,000	0.35%	1,833,600,000	5.00%	1,779,900,000	2.00%	1,801,100,000	5.00%
Inheritance and Estate Tax	73,000,000	2.82%	80,000,000	-9.09%	92,000,000	0.00%	93,700,000	4.58%
Tobacco Tax	126,100,000	0.88%	125,200,000	-5.15%	128,408,000	-1.00%	130,600,000	1.56%
Motor Vehicle Title Fees	11,300,000	-0.88%	11,300,000	0.89%	11,490,000	2.50%	12,000,000	5.26%
Mixed Drink Tax	55,200,000	7.18%	55,600,000	3.93%	55,638,000	6.00%	55,800,000	5.88%
Business Tax	134,200,000	8.05%	134,200,000	5.01%	129,061,000	2.00%	129,800,000	2.12%
Severance Tax	1,800,000	28.57%	1,700,000	13.33%	1,600,000	0.00%	1,400,000	0.00%
Coin Operated Amusement Tax	300,000	0.00%	300,000	0.00%	300,000	0.00%	300,000	0.00%
Unauthorized Substance Tax	800,000	100.00%	800,000	-42.86%	2,000,000	11.11%	1,600,000	6.67%
TOTAL DEPARTMENT OF REVENUE	\$ 11,087,200,000	4.04%	\$11,409,600,000	4.00%	\$11,399,798,000	3.59%	\$11,392,300,000	4.12%

GENERAL FUND ONLY (2)	\$ 9,270,300,000	4.07%	\$ 9,570,200,000	4.08%	\$ 9,540,298,000	3.53%	\$ 9,544,500,000	4.18%
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Growth over FY 08 Budget Document Estimate:

Total	\$322,400,000	\$312,598,000	\$305,100,000
General Fund	\$299,900,000	\$269,998,000	\$274,200,000

SELECTED TAXES	BUDGET DOC.	%	DR. FOX	%	FISCAL REVIEW	%	REVENUE DEPT.	%
SALES AND USE TAX	\$ 7,145,000,000	5.12%	\$ 7,116,200,000	4.50%	\$ 7,118,617,000	4.30%	\$ 7,116,800,000	4.51%
FRANCHISE AND EXCISE TAXES	1,536,300,000	0.35%	1,833,600,000	5.00%	1,779,900,000	2.00%	1,801,100,000	5.00%
INCOME TAX	216,400,000	6.34%	254,700,000	4.00%	263,220,000	7.00%	253,900,000	4.49%
ROAD USER TAXES	1,116,500,000	1.33%	1,124,800,000	0.96%	1,143,032,000	1.44%	1,138,600,000	1.82%
ALL OTHER TAXES	1,073,000,000	4.90%	1,080,300,000	2.30%	1,095,029,000	3.15%	1,081,900,000	2.60%

(1) Privilege Tax estimates are reduced by \$32 million for the earmarked portion of the tax.

(2) F&A calculated the General Fund distribution for all presenters.